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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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PRICE MOVEMENTS. Following the bear signal, Rails plunged precipitously to 138.18 (J on chart) while Industrials retreated under the 600 level (J - 599.10). The two J points were established after a string of no less than seven consecutive days of decline. On the basis of time alone, a rally was overdue.

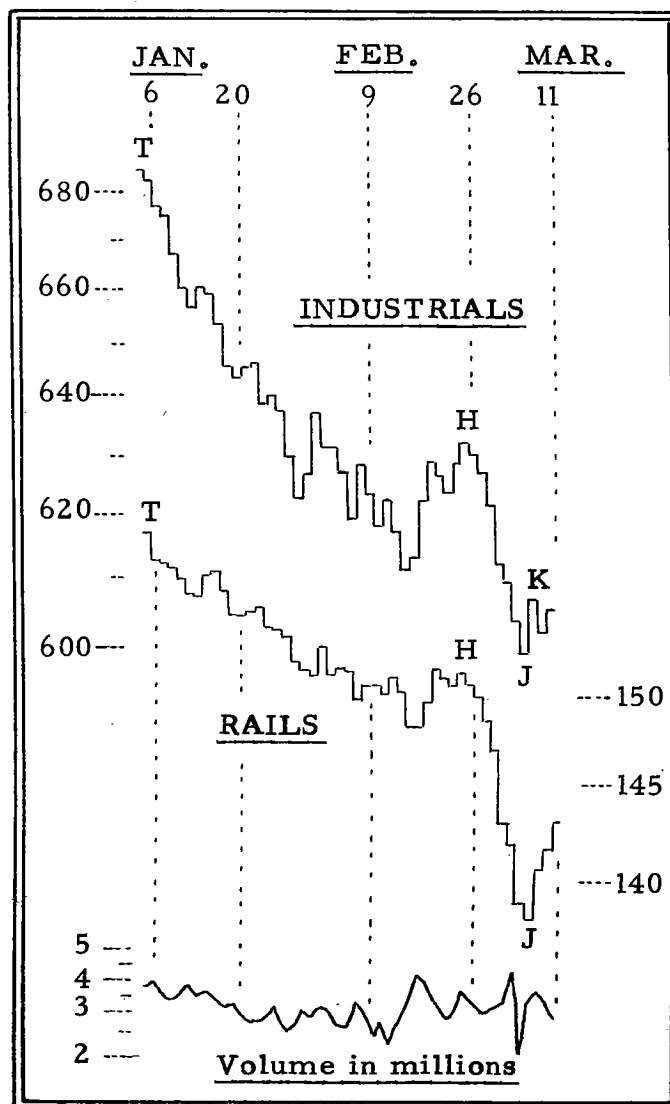
Volume dropped drastically on Friday (March 11) as Industrials approached their one-day rally peak at K (607.16). This was not bullish, and it suggested the possibility of a "sell-spot". Should both Averages now turn down and jointly violate the J points (on increasing volume), the primary downtrend would be taken as resuming.

It is important to remember that in bear markets dullness (particularly after a rally) often precedes the next decline. This is exactly the opposite of what we have learned to expect in bull markets. The old adage, "Never sell a dull market", applies to bull markets alone.

A study of past bear markets shows that stocks do not always plunge immediately after the bear signal is given. There have been a few cases (1899, 1906, 1910) where, following the bear signal stocks hung for weeks before turning down.

THIRD PHASE. In the past two weeks the Dow Theory has received more publicity than at any other time in its long history. Most of the "publicity" consisted of ridiculing the Theory and deriding its few practitioners. Magazines and newspapers from New York to Los Angeles have picked up the "bear market" theme; in the majority of cases the stories were written by people who know little about the stock market and nothing of Dow's Theory. To add to the confusion, Wall Street has joined the game wholeheartedly, and its "experts" have announced that this was "just another false bear signal such as occurred in 1953 and 1957".

Unfortunately, a little knowledge is worse than none at all. The 1953 and 1957 "bear signals" were simply secondary penetrations which came respectively in the first and second phase of the great 1949-59 bull market. The bear signal of March 3, 1960, however, came after this same bull market had exhibited all the characteristics associated with a classic third phase. Over and over again during the past year I have directed readers' attention to the third phase phenomena which were making their appearance as the bull



market matured -- the sky-rocketing low-priced stock index, the high volume, the long period (14 months) of heavy odd-lot buying balances, the low yields, the receding short interest ratio, the widespread public participation and the intensive market coverage by the nation's press.

Hamilton and Rhea were very specific in stating that bear market signals are only valid when they occur after the third phase of a bull market. The following passage from Rhea illustrates this point:

"Hamilton taught us to recognize the change of the primary or long term trend when, for example, we go from a bull market into a bear market. There are several factors which must be considered, such as activity, whether or not the advance has progressed into the third phase, etc., but the most important element in this summation is the consideration of the secondary reaction, because, when, in the third phase of a bull market, a fully normal secondary reaction occurs correcting a primary upswing, and the ensuing rally on low volume approaches but does not penetrate the old high, then if a later decline carries below the secondary low point, the primary trend is considered to have changed."

Ironically enough, many of the experts who were shouting "bear market" in 1957, while the market was in its second phase (see "Dow Theory Revisited", Barron's, December, 1958) are now insisting that the March 3 bear signal was meaningless. But talk cannot take the place of study in the stock market or anywhere else. The experts, in my opinion, are now fighting the tide, and they might as well be building sand castles to hold back the ocean.

The week following the bear signal finds the majority of services as bullish as ever, while advertisements are still telling readers about stocks to "double" and "triple" in the coming year. This service took an unpopular bearish position around the last quarter of 1959 despite the fact that bearishness has never been a spur to circulation. New readers would do well to go back and check some of 1959's "stocks to triple" against current prices. In most cases "yields have rallied" as the cynics on Wall Street put it.

BEAR MARKET ACTION. Most of the comments in these Letters (up to last week) have referred to the price action during bull markets. Subscribers will now have to get used to thinking "in reverse", for the price movements during primary bear markets are fundamentally different. Back in September, I called attention to the "bouncing", violent upside action which followed the September 22 lows. I wrote that after bull market reactions, there is usually a dragging, sidewise movement during which volume quiets down and informed investors accumulate.

The majority of bull market reactions end with at least a day or so of heavy selling. During bear markets, however, heavy volume may or may not accompany the end of a downward leg, and the reversal to the upside is often violent and sudden. This gives the "turn on a dime" or "bouncing" appearance so characteristic of bear market rallies.

The primary swings in both bull and bear markets are the long moves (both in duration and extent) while the reactions against the primary trend are sharper and take less time. Since bear markets usually last about 50% (or less) as long as the preceding bull market, it also follows that primary bear swings tend to be steeper and somewhat shorter than primary bull swings.

COMPARATIVE PSYCHOLOGY. The psychology during primary swings in both bull and bear markets is well worth studying. Just as bull market advances end in periods of great optimism, bear market legs terminate amid periods of excessive gloom. Often the correction (upward) of a bear market swing will begin simultaneously with the publication

of the actual bad news. Hamilton explained this when he wrote, "News known is news discounted."

The end of a bear market leg usually finds the public "dumping" their holdings while amateurs are eagerly putting out shorts. This, of course, suggests that the market is "over-sold". It is exactly this condition which lends impetus to bear market rallies, for on the turn to the upside the professional short seller will buy to register profits while the amateur short hastens to cover and thereby cut his losses. Floor traders, sensing the temporarily strong technical situation, throw their weight behind the move, and the rally is on its way. Towards the end of the advance the public (perhaps hoping that a new bull market has started) will come in for their share. Of such are bear market rallies made. A warning -- readers should remember that it is as difficult to identify the bottom of a primary bear swing as it is to call the top of a primary bull swing.

THE FIRST AND SECOND BEAR LEGS. A study of all past bear markets has shown the following: the first primary bear market swing averaged about 60 days during which Industrial losses averaged about 10% of the price of that Average. The second primary bear swing averaged better than 100 days and losses in the Industrial Average ran to about 22% of the price of the Industrial Average.

We know that the first primary swing in the current bear market started for Industrials on August 3, 1959, and continued to September 22, a period of about 7 weeks. Industrials on the first bear leg lost 62 points (678.10 to 616.45). Taking January 6 as the beginning of the second primary bear swing, this would suggest the possibility that the present swing (discounting minor rallies) will end around late March or early April after registering a loss of perhaps 120 to 130 points. If average action in previous bear markets means anything, these figures suggest that the current downward movement might terminate around 540-60.

Readers should remember that guessing as to the duration and extent of a primary swing is a dangerous business; I offer the foregoing merely as a point of interest, not as a forecast.

SUNDRY COMMENTS. Last week Business Week Magazine surveyed previous market signals and concluded that there is "scant cause to worry". The owner of Forbes Magazine told his readers that it would be "foolish to drop stocks which were purchased at reasonable levels for sound reasons." Newsweek interviewed an analyst who commented, "There's hardly anyone under 55 who believes in the Dow Theory anymore." Even Mr. Martin, head of the Federal Reserve, announced that his only worry was that people might take the stock market drop too seriously. Perhaps people are angry with Dow's Theory because it stands alone against the prevailing opinion. But it has done so many times before and managed to survive its detractors. On September 18, 1937, ten days after the bear signal which confirmed the end of the 1932-37 bull market Rhea wrote: "Except for 1929, there probably never was a time when soothsayers were so bullish as now."

At the mention of a bear market many people conjure up visions of 1929. There was only one 1929; it is possible that the peculiar circumstances which led to the "Great Crash" will never again be duplicated. Certainly margin calls have played no important part in the decline since January 5, and there is little in the action of the market so far to imply that urgent or forced liquidation has taken place. On the other hand, losses, in many cases, have been drastic despite the relatively thin volume. The stocks listed on the New York Stock Exchange represent a total of 6 billion shares outstanding, compared with about 1 billion in 1929, yet trading volume is lower now than it was in 1929.

This means that millions of stockholders have been "locked in" with paper losses which were caused by very few actual transactions on the Exchange. What this relatively new phenomenon

portends for the future no one can know. Each bear market has its unique set of circumstances. It is possible, for instance, that liquidation will grow more urgent as prices drop to successively lower levels.

PUTS AND SHORTS. Readers are asking me about short selling. In general, shorts should be "gotten off" following a sustained rally in a bear market when, after a dip, one or both Averages fail to better the preceding highs and volume grows dull. Point H on the chart was just such a spot, but, unfortunately, we did not then know that the primary trend was down. H was a typical "sell-spot" in a bear market, the converse of a "buy-spot" in a bull market.

Rather than shorting, however, I suggest buying "puts" for the average investor. Puts are options to sell a given stock at a fixed price within a specified period of time. Puts have the advantage of limiting losses (only the actual price of the put is at stake). Puts eliminate a great psychological handicap which faces short sellers -- being "whip-sawed" or frightened out on rallies. Capital gains can be taken on put options which extend for longer than six months. Further information on puts can be furnished by your broker. The book, "Understanding Put and Call Options" by Herbert Filer, is published by Crown Press, 11 West 42 St., N.Y.C.

The following stocks have "topped" and are, in my opinion, deserving candidates for puts. International Harvester, Union Carbide, American Cyanamid, duPont, Heyden-Newport, U.S. Rubber, Firestone, N.Y. Central R.R., Erie, Illinois Central, B & O, Chesapeake & Ohio, Masonite, National Lead, Kaiser Aluminum, Reynolds Metals, Ford, Chrysler, Republic Steel, Wheeling Steel, Colorado Fuel & Iron, International Paper.

Campbell Red Lake and Dome Mines look strong and might be purchased as a play on the golds.

NOTE; I have received such a flood of letters (a good portion of them pertaining to "false bear signals") that I am physically unable to answer them. This writer has been in bed for a week with an infected ear, and the doctor tells me that I must now choose between personal correspondence and market analysis. I do read each letter that arrives here, however, and to all of those who have taken an interest in the Theory I extend my heartfelt thanks. I will attempt to answer questions of general interest in future Letters.

ANOTHER CONFIRMATION. The following is from the Neill Letters of Contrary Opinion, Saxtons River, Vt., "...we may soon have another confirmation; that the generally expected recession of 1961 has already commenced (in the first half of 1960).

(Written: March 14, 1960 2 P.M.)